BBVA | RESEARCH

Economic Outlook

Peru

Fourth Quarter 2012
Economic Analysis

- **The main central banks in the world take decisive measures** and reduce the chance of a major external deterioration.
- **Locally, growth forecasts are revised up.** Domestic demand will continue to support output in 2013 and from then on entry into operation of mining investment projects will provide an additional temporary boost.
- **Inflation will return to target range later than expected** in the second half of 2013..
- **Capital inflows will continue to push the local currency up** although at a more moderate pace due to reduced availability of financial instruments, changes in foreign-exchange intervention strategy of the Central Bank and regulatory measures.
- **The Central Bank will maintain its policy rate at the current level.** In a context of currency appreciation, any monetary policy adjustments will be made through increases in reserve requirements.

Index

Closing date: October 30, 2012

1. Summary

Decisive intervention by central banks around the world has limited the possible occurrence of a systemic risk scenario. In the case of the euro zone, the existence of a lender of last resort for public debt, under fiscal strict conditions, has dissipated fears regarding the irreversibility of the common currency and created a path for progress to continue toward a new institutional framework. In the United States the Federal Reserve's injection of liquidity has anticipated the potential impact of a major fiscal adjustment in the country at the start of next year. To sum up, uncertainty has receded and the global outlook is somewhat clearer. In this context, we expect the world economy to continue to recover steadily, with rates of growth of between 3% and 3.5% in 2012 and 2013.

For Peru, we have revised economic growth upwards within the forecast horizon. In the short term, domestic demand has performed better than expected, and advance indicators suggest that this strength will be maintained for the rest of the year. As a result, GDP will end at around 6% in 2012. Next year, the ongoing major investment projects and the start of new ones will provide continued support for output. Together with increased social spending and higher wages in the public sector in the 2013 budget, this suggests growth in 2013 will be 5.6%. The major mining projects currently under construction will enter their production phase in 2014. This will not only boost the mining sector, but also activities linked to it. Economic growth will speed up temporarily in the medium term, with an average annual rate of close to 6% until 2016, supported mainly by exports.

With respect to prices, inflation will return to target later than forecast, in the second half of 2013. Three factors support this view. First, we have an upward trend in the international oil price, which at a local level will be passed on quicker to final sale prices due to cuts in the price stabilization fund. Second, the major rise in the international price of foodstuffs in the third quarter, which was greater than expected, will be passed on with a time lag to consumers; in other words, its biggest impact has not yet been felt, and should kick in at the start of 2013. Finally, domestic demand will continue to grow at a faster pace than output and slack will be taken up. Although convergence of inflation to the target range has been delayed, mainly due to recurring supply shocks, the duration of its deviation has led to an increase in medium-term inflationary expectations at close to the upper limit of the range. As this deviation extends into the second half of next year it could affect expectations still more and generate second-round effects.

We also expect capital inflows to continue strengthening the local currency, as they have until now. As a result, the exchange rate will close at around PEN 2.50/USD at the end of 2013. Demand from non-domestic investors for sovereign bonds and corporate securities will continue, the banks' external liabilities will increase, and capital will flow into the country in the form of foreign direct investment. However, the rate of these inflows will moderate somewhat for two reasons: reduced availability of financial instruments resulting from the Central Bank's strategy change with respect to foreign-exchange intervention, which will make local-currency positions more risky; and regulatory measures.

With respect to monetary policy, the Central Bank will maintain its reference rate at 4.25% throughout 2013. If medium-term inflationary expectations increase further, or demand pressures intensify, any possible monetary policy adjustments will be made through increases in reserve requirements, as has already been the case since the end of the third quarter. The use of this instrument rather than the policy rate will avoid upward pressure on the local currency, in a situation where there has already been significant effort to moderate it. In addition, macroprudential measures will be coordinated with the other authorities, as has been done already. It is important to mention that Peru is, after Brazil, the country that has used such measures most in the region. Although their use helps limit the probability of macroeconomic vulnerability, they also involve a cost, above all in an economy where financial intermediation is still relatively low, increased demand for credit is based on structural elements such as increased permanent income and reduction of informality, and baking system's indicators are sound.

Finally, the main risk factor in our forecasts continues to be Europe, although its probability has been reduced due to support by the European Central Bank in what is a difficult situation. The most important source of uncertainty is associated with the chance of a major "accident" on the path toward fiscal and financial sustainability. Although the impact on local activity would be significant, the Peruvian economy has the fiscal and monetary strength to mitigate it. In this scenario, the rate of growth would be affected moderately in 2013 and 2014 before beginning to recover. At the same time, the public and foreign balances would be temporarily weakened, but this would be manageable.

2. Central bank actions reduce tail risks

Bold actions by central banks have reduced uncertainties in the global economic outlook, but challenges remain

The world economy is expected to continue its soft recovery, with GDP growth of 3.5% in 2013, up from 3.2% in 2012. The outlook is supported by lower risk aversion after influential decisions taken by central banks, especially the ECB. However, three factors stand out that could undermine the outlook: first is the risk of a re-emergence of euro break-up fears; second is the threat of the so-called US fiscal cliff (a spending-cut and tax-hike package worth 4% of GDP) due to take effect at the beginning of 2013 that would push the US economy back into recession; and third, is the risk of a slowdown in the emerging economies, especially in China.

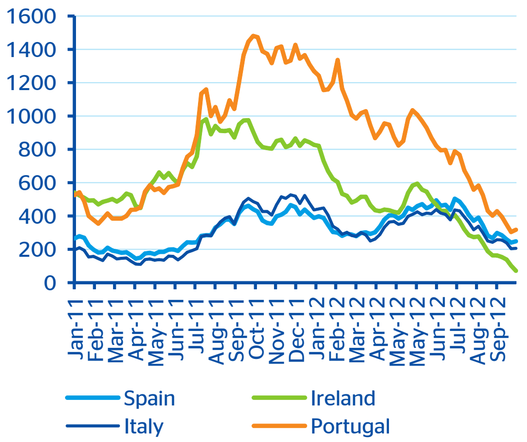
Central banks to the rescue; other policy makers should follow

Against a backdrop of uncertainty and threats to the world economy, policy makers – in particular central banks in the eurozone and the US – have taken steps to avert a systemic event that could have been comparable in scale to the financial crisis of late 2008.

"... whatever it takes..."

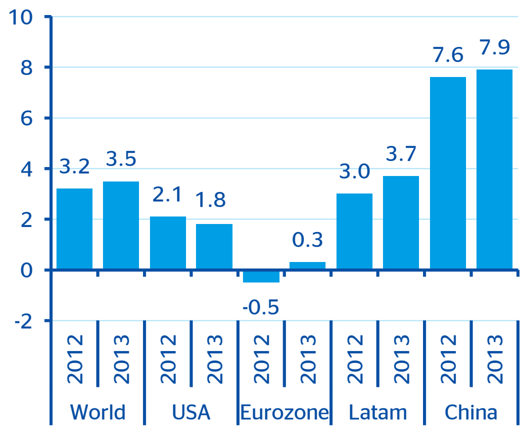
In our view, European Central Bank (ECB) President Mario Draghi's announcement of a new bond-purchase program (Outright Monetary Transactions, or OMT) in late July was a decisive step toward ending the debt crisis in Europe. Under certain conditions, the ECB could intervene in secondary sovereign-debt markets. The ECB's move came after a eurozone summit in June where leaders reached agreement on a broad roadmap towards a single banking supervisor, far-reaching plans on fiscal issues, and growth-supporting measures. The ECB has committed itself to buy unlimited quantities of sovereign bonds of those countries that seek financial aid from Europe's funds (European Financial Stability Fund & European Stability Mechanism) with "strict and effective conditionality." Tensions in financial markets have eased significantly since June (see Chart 1).

Chart 1
Financial Stress Index for Eurozone countries[1]



Source: Haver and BBVA Research

Chart 2
GDP growth rate (%)*



(*) Argentina, Brazil, Chile, Colombia, Mexico, Peru y Venezuela.
Soure: BBVA Research and IMF

Other elements have recently reinforced the currency union in Europe. First, the permanent fund that will deal with any new bailout in the eurozone (the ESM) has been put in place. Second, the process for achieving a banking union in Europe continues moving forward, albeit slowly.

We expect the eurozone to come up with a full package eventually that will reinforce its governance. As we have long argued, such a package should comprise a banking union, a fiscal union, and a lender of last resort facility. Progress has been made on all of these fronts which, though not ambitious enough yet to revert the current dynamic quickly, will alleviate pressures over time. In the short term, the ECB's program and the ESM support under fiscal conditionality creates a benchmark to deal with difficult funding situations that countries such as Italy and Spain could face. At the same time, effective implementation of the banking-union plans and further definition of the fiscal-union design will be key to the long-term sustainability of the eurozone.

"… as long as needed…"

With the US economy growing slowly, unemployment remaining persistently high, and amid huge uncertainty in Europe, a pre-electoral gridlock over how to bring the US deficit down was the last thing the US economy needed. Against this backdrop, the Fed did not hesitate to act. First, and in accordance with its "forward-guidance policy," the Fed announced that it intends to keep rates at their current low levels until at least mid-2015. Second, the Fed announced a new round of quantitative easing (QE) to support growth and employment recovery. This further monetary loosening will be different from previous rounds: the Fed will purchase mortgage-backed securities (MBS) rather than Treasuries, and it will continue with this policy for a considerable period of time, even after the recovery strengthens.

In our view, by embarking on QE3 and extending policy guidance, the Fed is buying insurance against the "fiscal cliff," but it is not a silver bullet. In our baseline scenario, an agreement will be reached to avoid the complete package of automatic spending cuts and tax hikes from taking place. Yet we also expect some form of fiscal consolidation that will act as a drag on growth. The Fed has done its part to give the economy the boost it needs to avoid slipping back into recession in 2013. As previous QE programmes showed, they prompt inflows to emerging economies, decreasing risk premia, and lowering funding costs.

1: The Financial Stress Index (FSI) is a synthetic indicator of: risk measures (5-year CDS, CDS of non-financial corporations and financial debt), volatility (stocks, interest rates and exchange rates) and liquidity stress (3-month spread between interbank and risk-free asset).

Central bank responses are not enough for a firm expansion

The world economy may have avoided decelerating to its slowest growth of the last 30 years (apart from the 2009 great recession) but a low growth environment continues. The advanced economies have been losing momentum since 2011. More recently the emerging economies have been hit too (see Chart 3). Brazil's economy almost stalled in the first half of the year; India's GDP grew by 5.3 and 5.5% y/y in the first and second quarter, respectively, the slowest pace since the beginning of 2009; and in the third quarter of the year the Chinese economy slowed to a rate of 7.4%, the lowest growth rate since 2009 although the more recent data points to a bottoming-out.

Under our baseline scenario, growth in the eurozone is likely to gain momentum in 2013. Although GDP will contract in 2012 (-0.5%), it should rebound slightly in 2013 (+0.3%). In the US, we have maintained our forecasts: growth will remain at around 2% in 2012 and 2013. The main downward revision in our October scenario corresponds to China (by -0.2 pp in 2012 and -0.4 pp in 2013), although its growth rate will still remain close to 8% in both years due to policy stimulus. Other emerging economies will make up for this slack: the outlook for growth in Latin America is revised slightly upwards in 2013, when the region will grow by 3.7%, up from a 3% growth rate in 2012.

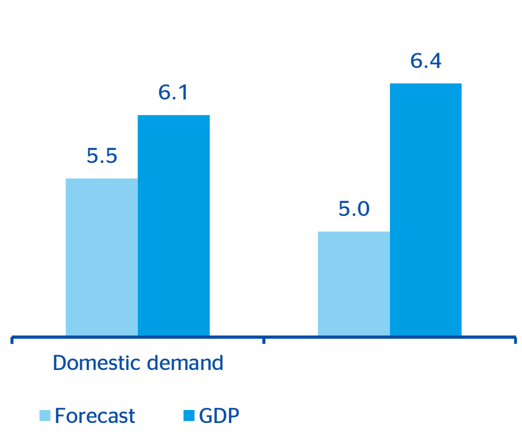
All in all, the world economy is expected to continue undergoing a soft recovery with a GDP growth between 3% and 3.5%. Yet this scenario relies on several key assumptions, in particular on whether European policy makers will deliver on their commitments. In the meantime, the ESM/ECB's intervention should be enough to bring Spanish and Italian yields back to levels consistent with the mid-term sustainability of the public debt. This implies that both countries retain investment-grade ratings and deliver on their fiscal commitments (or are granted extensions to meet them, hopefully on structural balances). Finally, in this scenario, Greece should remain in the euro, which would, in turn, require further support from Europe in the form of additional funding and/or a longer period to fulfil fiscal conditionality. Based on past experience, many things can still go wrong, but policy makers have shown a tendency to find solutions when crunch time approaches.

3. Peru: improved growth prospects

The economy will be driven by domestic demand in 2012 and 2013

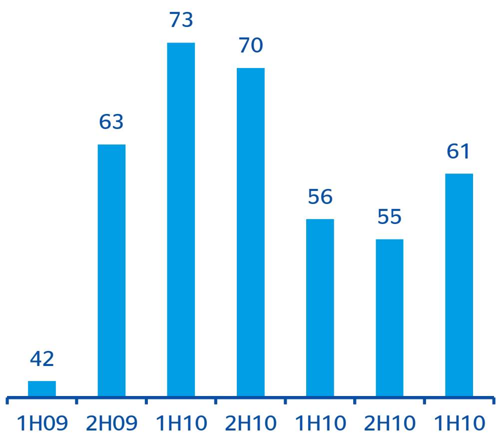
EIn the first half of the year the Peruvian economy grew at 6.1%, more than we forecast in our previous quarterly report (Chart 3). On the expenditure front, domestic demand supported growth. Private investment recovered from the slump at the end of 2011 amid improved business expectations (Chart 4), while household consumption continued to post solid growth supported by a major expansion in quality employment (with a year-on-year rise of 8% until the start of the year). In contrast, foreign demand weakened and since April the volume of exports has been shrinking in year-on-year terms.

Chart 3
GDP in the first half of 2012 (y/y % change)



Source: BCRP, BBVA Research Peru

Chart 4
Business confidence
(average index for the period)



Source: BCRP, BBVA Research Peru

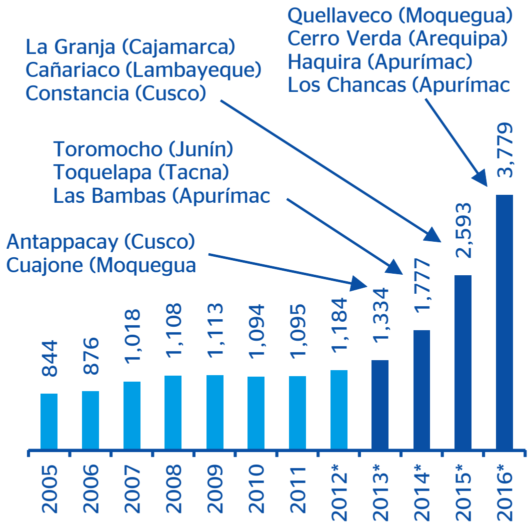
The available economic indicators for the third quarter suggest that the positive performance of domestic demand will continue through the rest of the year. As a result, the outlook will be more positive than we expected three months ago. On the consumption front, sales of new family cars and imports of final consumer goods continue to grow at double-digit rates. On the investment front, cement dispatches and imports of capital goods is still growing strongly, while business confidence continues to recover. In addition, public capital spending has been growing at around 20% and will maintain this pace for the rest of the year. As a result, we estimate that Peru's economy will close the year with growth of around 6.0%, higher than our previous estimate of 5.6%.

Maintenance of large investment projects and the launch of new ones will continue to support output in 2013. In the mining sector, for example, three major projects will enter their construction phase (the extension of Cerro Verde, Quellaveco and Constancia), with a total estimated investment of around USD 9 billion. Investment in this and other sectors such as energy and retail will continue to boost adequate job creation, which in turn will bolster private consumption. Household spending will also be supported by increased social transfers and wage increases of over USD 1,300 million, which have been included in the 2013 budget. The good performance we anticipate for domestic demand will offset the greater weakness this report suggests for the export sector (the strength of China will weaken somewhat). Overall, economic activity will grow by around 5.6% next year (5.3% in our previous report).

Maturing mining projects will speed up exports starting in 2014 and temporarily boost growth

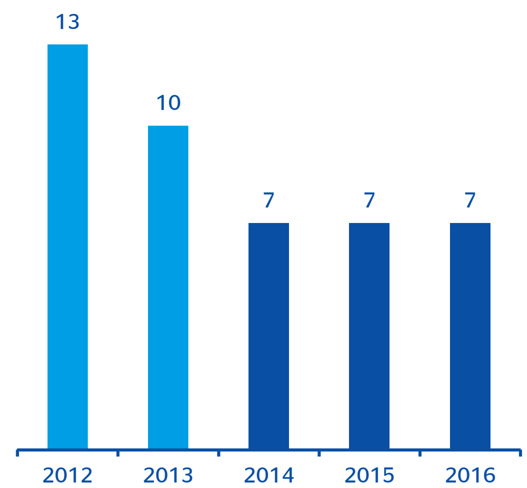
The entry into operation starting in 2014 of major mining projects currently in the construction phase will substantially increase the production of basic metals. These projects include Las Bambas, Toromocho, Quellaveco and the extension of Cerro Verde, and will triple copper production in a four-year horizon (Chart 5). In the case of iron, production will multiply by a factor of seven. This will not only energize mining (increased exports on the expenditure side), but also the activity of the sectors linked to it, such as manufacturing and services, and continue to support job creation.

Chart 5
Copper production (Thousands of MT)



Source: BCRP

Chart 6
Private investment (y/y % change, forecast)



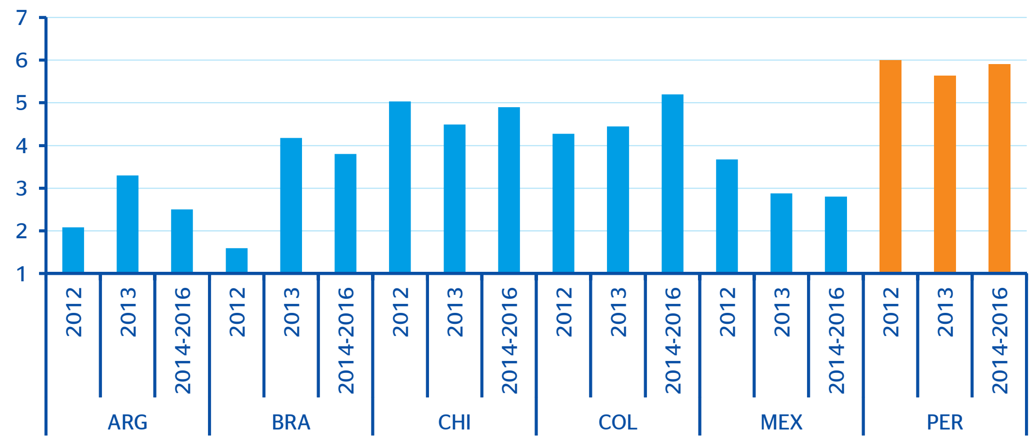
Source: BBVA Research Peru

Thus our forecasts consider that the main source of growth for the 2013-16 period will be the export sector. We estimate that domestic demand will grow at a more moderate pace, reflecting slower private investment (Chart 6) due to the conclusion of the major mining projects mentioned above. At the same time, business could adopt a more cautious attitude in an economic environment that is weakened on two fronts: globally and also locally, by questions of an environmental nature that could delay new projects to exploit natural resources. However, the slowdown in private investment could be restricted if, for example, the public authority promoting it (ProInversión) managed to speed up the process of granting the infrastructure projects it has in its portfolio, which currently total over USD 10 billion.

Peru will continue to lead the way in growth in the region

The favorable growth outlook for Peru over the next five years (Chart 7) is based on solid domestic demand and a temporary boost in exports. However, to sustain growth rates of around 6% in the future Peru will have to: (i) substantially reduce the infrastructure and competitiveness gap, in particular in transport, which will require the identification and clearance of bottlenecks in the public and private investment processes; (ii) speed up the process of generating human capital, in terms of coverage and quality of the education and health services; (iii) provide more dedicated support to innovation and technology; (iv) continue to improve the business climate; and (v) guarantee security and law and order for its citizens.

Chart 7
Latam: Economic growth forecasts (y/y % change)



Source: BBVA Research

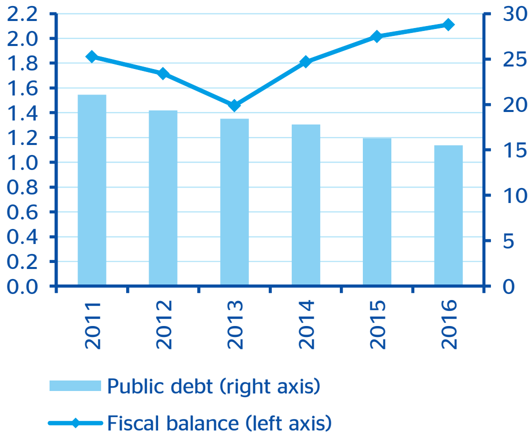
The fiscal balance will be in surplus in the forecast horizon, so the public debt will continue to fall

The public sector accounts will again end the year in surplus. The positive difference between income and expenditure will increase in 2012 to around 1.7% of GDP (Chart 8). This is the result of two factors: first, the strength of economic activity has generated a higher tax revenues (up 6.4% in real year-on-year terms for the first three quarters); second, part of the positive fiscal balance is still supported by the difficulties in hitting public capital expenditure targets. There is a lack of new large-scale public investment projects, and in some cases the management capacity to manage existing projects is not available, or there are obstacles in the processes that cannot be resolved.

Over the following years, stronger domestic demand and, subsequently, exports, will continue to provide support for tax revenues and give room for an increase in public spending. At present, the government budget for next year includes a 10% rise in expenditure in real terms, and we expect this trend to continue in the medium term. Given this situation, four questions have to be addressed. First, the quality of public expenditure has to be preserved at all levels. In this respect, it is a positive sign that the budget is being increasingly covered by revenues. This stimulates the definition of parameters for assessing the targets that the government wants to meet. Second, a disproportionate increase in current expenditure should be avoided. Priority should be given to investment, because it is more closely linked to long-term growth, to which is added that is more ductile to be used in a countercyclical manner. Third, the current concentration of public investment in small-scale projects is a cause for concern. According to the local consultancy APOYO, not including the expansion of the Electric Train project the average investment in public investment projects amounts to USD 8 million. The disadvantages this generates are associated with the increased demand for management capacity to run a large number of projects and the lack of organization there could be between them. This suggests a limited impact on competitiveness. Finally, even though Peru has run a budget surplus since last year, our estimates for the structural fiscal balance continue to be negative. Although we do not expect this indicator to worsen in the medium term, it has to be kept in mind that an unforeseen reversal of the terms of trade would sink us back to a deficit zone, which would reduce the room to carry out a countercyclical fiscal policy.

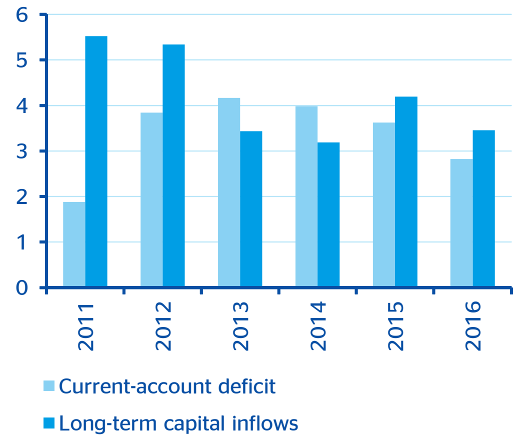
Overall, our forecasts for the fiscal balance are favorable for the next few years. In this context, we estimate that the public debt ratio will continue to fall to a level of close to 16% of GDP in 2016.

Chart 8
Fiscal balance and gross public debt (% GDP)



Source: BCRP, BBVA Research Peru

Chart 9
Current-account deficit and long-term capital inflows (% GDP)



Source: BCRP, BBVA Research Peru

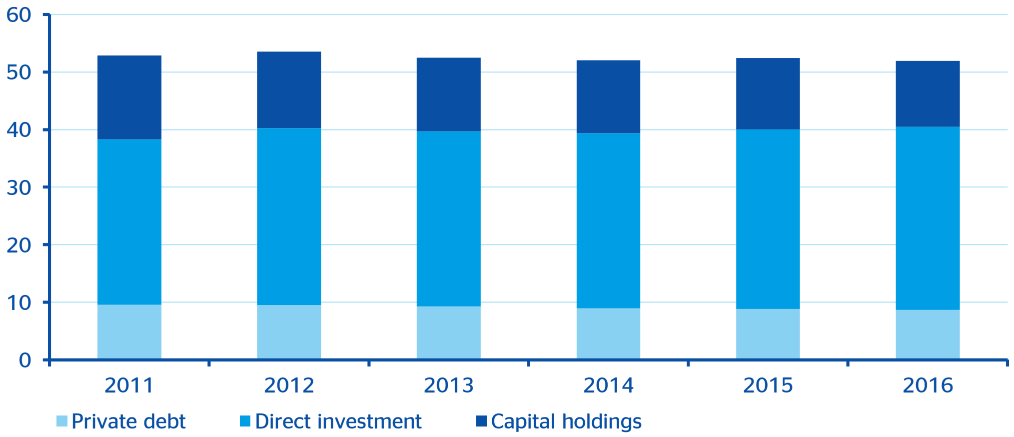
Higher domestic demand will increase the balance of payments current-account deficit

Our expectation of a stronger domestic demand, together with the slowdown of exports and a fall of the terms of trade, will increase the current-account deficit in 2012 and 2013 (Chart 9). However, in the medium term, the re-arrangement of the growth factors on the expenditure side, with a greater temporary support for exports, will favor the trade balance and steadily reduce its deficit.

It is worth noting that our long-term capital inflow projections suggest current-account deficits will be financed easily. In this scenario, the Central Bank will continue to accumulate international reserves, although at a slightly slower pace, above all starting in 2014, which will be mainly determined by more volatile short-term capital flows.

In addition, we consider that long-term external liabilities in the private sector will remain stable, both as a percentage of GDP (around 50% of GDP) and in its composition (Chart 10). We expect higher mining sales will increase company profits in this industry, maintaining its tendency to finance new investment using its own capital. As a result, the share of foreign direct investment (FDI) in long-term liabilities will remain high. This makes the current account more stable, given the anticyclical character of profits from FDI.

Chart 10
Long-term external liabilities in the private sector (% GDP)



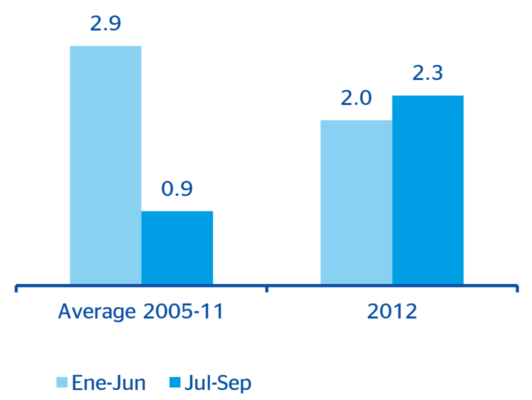
Source: BCRP, BBVA Research Peru

4. Inflation will return to the target later than forecast

Inflation has consistently been off target and medium-term inflationary expectations have increased

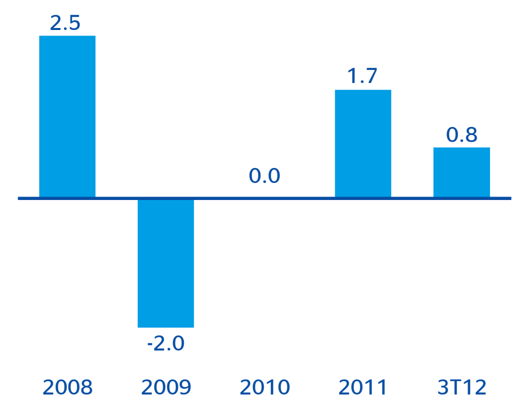
During the year inflation remained above its target range (2% +/- 1 percentage point), with a figure for September of 3.7%. The convergence process was expected to speed up in the second half of the year, but this did not occur and the deviation has now extended over a year and a half. Normally, food prices rise at the start of the year during the wet season in agricultural areas and then fall back in the following months. This reversal has not occurred so far because the weather conditions have not been favorable (Chart 11).

Chart 11
Food prices (year-on-year % change)



Source: BCRP and BBVA Research Peru

Chart 12
Deviation of inflation with respect to the 2% target: contribution of non-core component (in pp)



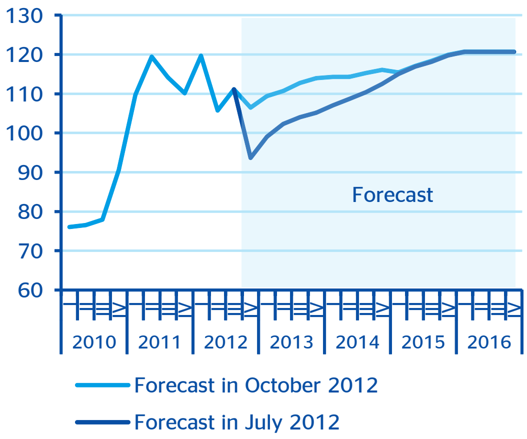
Source: BCRP and BBVA Research Peru

This supply shock is in addition to the previous ones (imported food products, local climate conditions, oil). It is the recurrence of these shocks that to a large extent has maintained inflation outside the target range since last year, contributing over 1.5 percentage points in 2011 (Chart 12) and around 1 pp now. In an environment in which the rate at which prices move is consistently over 3%, inflationary expectations for 2013 and 2014 have increased and stand at close to the upper limit of the Central Bank's target range. In other words, in a horizon in which supply shocks should tend to dissipate, the public expects inflation to continue relatively high. This expectation could be incorporated into the process of price formation and thus generate second-round effects.

Together with the delayed impact of the increased international prices of foodstuffs, this would postpone the process of convergence to the target until the second half of 2013

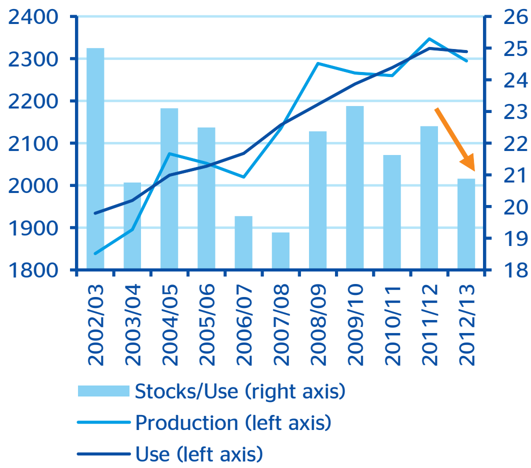
Both supply and demand factors suggest that the outlook for prices could in the future be more complex than we expected in our previous report. On the supply side two elements will print some resistance to inflation in the coming months: the upward trend in the international oil price (Chart 13); and the delayed impact of increased prices of imported foodstuffs. In the case of oil, liquidity injections that will continue in the coming months through the US Federal Reserve's QE3 will lead to increased demand for assets perceived as of greater risk, among them commodities, and to a rise in the dollar. This will take place in a context of political tension in the Middle East and little slack in global oil supplies. In addition, a strained fiscal situation in a significant number of the main oil exporting countries that could lead them to make small production cuts, which could have a further significant impact on the price. Locally, the rising international oil prices we expect will be reflected in higher consumer prices as the Fuel Price Stabilization Fund no longer covers gasoline.

Chart 13
International Brent crude price (USD/barrel)



Source: Haver and BBVA Research Perú

Chart 14
Cereals: Global production, use and stocks (millions of metric tons)

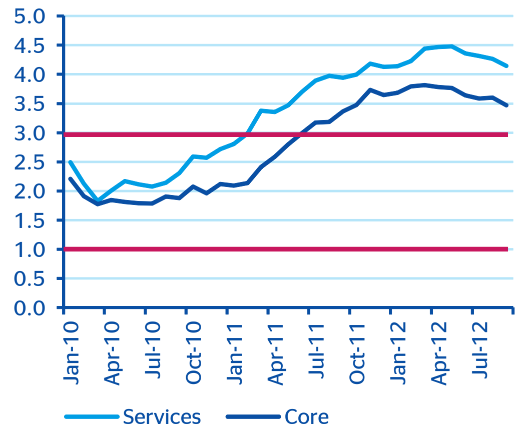


Source: FAO

The prices of imported foodstuffs (soy, wheat and corn) increased significantly in the third quarter of 2012 to levels higher than expected in our previous report. This is largely due to the major impact of climate problems affecting the main production areas in the world (see Chart 14). Although in recent weeks there has been some correction in international prices, they remain high. Empirical evidence suggests that when there are episodes such as these the effect on the price of final goods is delayed. In other words, we have still not seen the bulk of the impact of the higher prices of these commodities on local inflation, which we expect to see in 2013. It is also important to mention that the rising prices of these goods has been less marked than in 2008, so the impact on consumer prices will also be more limited than at that time.

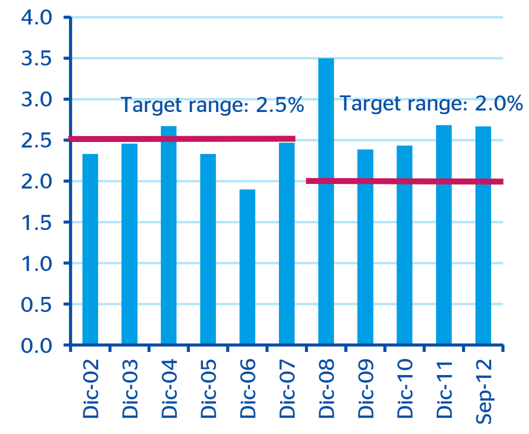
On the demand side, domestic expenditure will continue to grow faster than output and slack will tighten. As a result, demand pressure on prices will increase. This can be partly be seen already as core inflation is above the target range, and even items more closely linked to demand within this measure of inflation, such as Services, are not within target (Chart 15). Another indicator that supports the same idea is the rate of utilization of installed capacity of non-primary manufacturing industry, which is at all-time highs; although the sector as a whole still shows some slack, there are sub-branches in which this is no longer the case.

Chart 15
Core inflation and Services inflation
(% year-on-year change)



Source: BCRP and BBVA Research Peru

Chart 16
Inflationary expectations for two years ahead (%)



Source: BCRP and BBVA Research Peru

The effect of these two supply shocks (oil and imported foodstuffs) and the strength of domestic demand in the coming months suggests that inflation will not fall to the target range (and remain there in the future) until the second half of 2013. It will therefore have remained for two years above target, which will continue to affect inflationary expectations in the medium term (Chart 16).

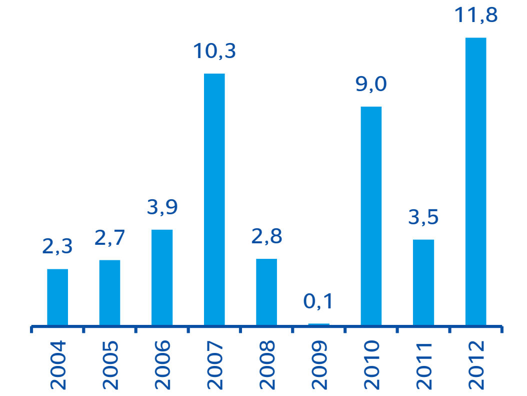
5. Capital inflows will continue to strengthen the local currency

The Peruvian currency continues to appreciate (Chart 17), and so far this year it has gained close to 4%. There are two reasons for this: first, there ample liquidity in the international markets and global risk aversion has fallen after the probability of a very difficult scenario in Europe receded; second, the Peruvian economy continues to grow steadily and its vulnerabilities are gradually being reduced. In this context, there is a great appetite for domestic assets and capital inflows have strengthened the local currency. Although we do not rule out temporary episodes of turbulence, we consider that the upward trend for the PEN will continue over the coming months, so the exchange rate will be at around PEN 2.50/USD at the end of 2013, which we consider to be close to equilibrium.

Chart 17
Exchange rate, PEN/USD

Source: BCR, BBVA Research Peru

Chart 18
Central Bank: Net purchases on the foreign-exchange market (USD billions)



Source: BCR, BBVA Research Peru

This scenario will mean that the Central Bank will continue to intervene in the markets to moderate the rate of appreciation of the local currency. It is important to note that so far this year foreign-exchange interventions have amounted to around USD 12 billion (Chart 18), a record figure that is equivalent to nearly 25% of the net balance of international reserves at the close of 2011. This involves a cost. Economic growth can only absorb part of the liquidity in local currency that is injected as a result of the interventions. The rest has to be sterilized, and while the yield on international reserves is under 2% (e.g. the interest rate of a 10-year US Treasury Bond is currently at around 1.70%), the cost of sterilization using deposit certificates or time deposits by banks or the public sector is at least double this. As foreign-currency purchases increase, the losses incurred will also do so. This could in the end make monetary policy more difficult.

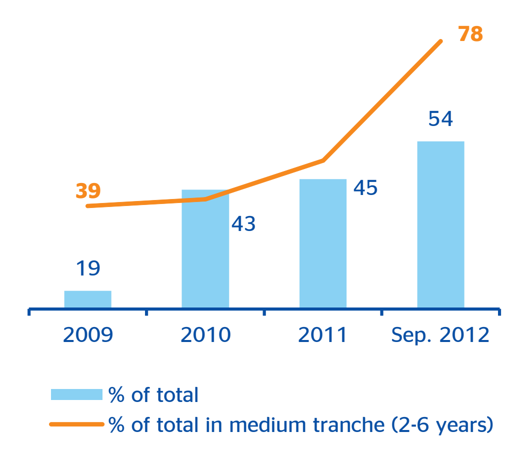
That is why the Central Bank will combine foreign-exchange interventions with complementary measures of its own, or coordinated with other economic authorities. In the case of its own measures, it recently modified its intervention strategy on the foreign-exchange market. Now it not only makes foreign currency purchases when the exchange rate is under pressure, but it has also begun to do so when there are no pressures of this kind, thus weakening the local currency. The aim is to increase exchange rate volatility, making it more risky to support a stronger local currency and thus reduce the attractiveness of these operations (which will eventually lead to a reduction in foreign-exchange interventions). The measure was implemented only a few weeks ago, so it is still premature to reach a conclusion on how effective it is. An increase to the operational limit to foreign investments by private pension funds can also not be ruled out. This would provide some support to local demand for dollars. In this case, the banking regulator proposed a few days ago to reduce the limit on the open exchange positions (from 15% to 10% of effective assets) and the net foreign-exchange derivatives position (from 30% to 20%). This would reduce the possibility of taking long positions in favor of the Peruvian sol. The measure will enter into force at the start of 2013.

Capital inflows will be not only for the acquisition of public debt, but also corporate securities

Capital has flowed into the Peruvian economy through a variety of channels. One of them is the sovereign bond market, where foreign investors have increased their positions (Chart 19). On some parts of the yield curve the trend is now close to 80% of the total issuance. Most of Peru's public debt is supported by relatively attractive yields compared with international interest rates, an appreciating local currency and low exchange-rate volatility (reduces the risk of investment).

In this situation, the yields demanded by the markets have fallen considerably, and in some cases, in particular for sovereign bonds with a maturity of under 10 years (Chart 20), their levels are actually similar to the monetary policy rate (4.25%).

Chart 19
Sovereign bond holdings by foreign investors



Source: MEF, BBVA Research Peru

Chart 20
Yields of sovereign bonds maturing in 2020 (bps)

Source: Bloomberg, BBVA Research Peru

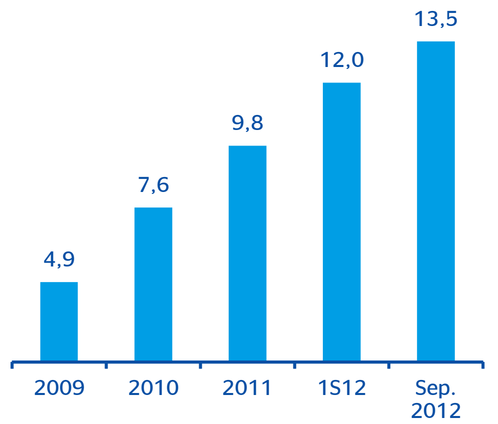
We expect that in the upcoming months capital inflows will continue to increase sovereign bond positions because these securities will remain attractive and the financial conditions at a global level will still be lax. However, the rate of inflows will slow because the level of holdings by foreign investors is already high and there will be no significant public debt issuance by Peru in 2013 (there will be a fiscal surplus). In any event, demand will be more geared toward the longer tranches, where holdings by foreign investors have so far increased to a more limited extent and prices have risen less (the yield curve has steepened)

A second channel of capital inflows is issuance abroad by Peruvian non-financial corporates. This was infrequent until a short time ago, but the appetite shown by international markets and the relatively low yields demanded have encouraged these issues. In recent months, for example, two companies in the mining sector issued shares and bonds globally to finance their local expansion, and obtained around USD 700 million. There are other operations in the portfolio such as these. In a context in which the Treasury does not have more financing needs and thus the issue of public debt is limited, the appetite of foreign investors for the securities of Peruvian companies will continue to boost the inflow of foreign currency into the economy.

In addition, more external funding by the banking sector and foreign direct investment

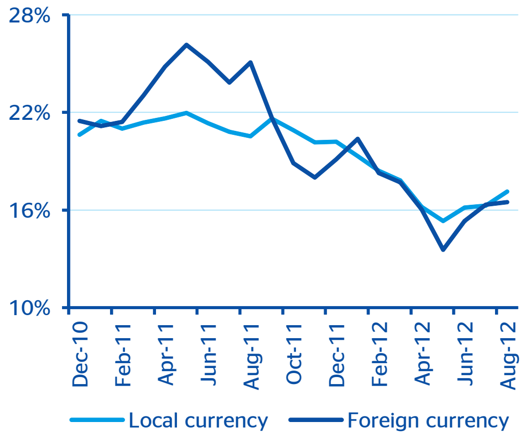
A third vehicle through which the local supply of dollars has been increased is the funding obtained by banks abroad (Chart 21). Credit demand remains strong, reflecting the population's higher income and falling levels of informality. A significant part of this demand is in foreign currency (Chart 22), taking advantage of low dollar interest rates and the expectation that the local currency will continue to gain. In the case of deposits, however, the situation is different. It is more one of de-dollarization. The banks have tried to meet the greater demand for credit but without incurring greater currency mismatches. This has led them to increase their external liabilities (close to 80% of this balance is long term). Although the banking regulator has proposed increasing capital requirements for banks when the borrower shows a currency mismatch between income (in soles) and finance sought (in dollars), which will make foreign-currency credit more expensive, the impact of the measure is believed to be limited. Thus as international interest rates remain low and the Peruvian currency continues to rise, banks will probably still increase their funding abroad to meet the greater demand for credit. As a result, capital will continue to flow through this channel.

Chart 21
Balance of external liabilities of the Peruvian banking system (USD billions)



Source: BCR, BBVA Research Peru

Chart 22
Lending by the financial system to the private sector (% y/y change)



Source: SBS, BBVA Research Peru

Finally, it is important to mention that the capital inflows through foreign direct investment gathered pace in the first half of the year to a record high, with a gain of 30% on the first half of 2011. Much of this was reinvestment of profits generated by foreign companies. We consider that this will continue in the upcoming quarters to take advantage of business opportunities that will still be generated by the significant growth of the Peruvian economy, or to continue with progress on the construction of major projects such as in the case of the mining sector.

6. Is the monetary policy dilemma back?

Inflation is persistently outside the target and domestic demand will continue strong…

The policy rate has remained unchanged at 4.25% since May. This is despite inflation being outside the target range, but the deviation has been mainly related to supply shocks. On the GDP side, the strength of domestic demand has offset the weakness of the export sector. As a result, growth has been only slightly above potential in an environment in which the output gap was still negative. Finally, uncertainty regarding conditions abroad suggest act very prudently.

The outlook for the future is somewhat more complex. First, the recurrence of supply shocks has led inflation to be persistently higher than the target, and we expect that it will not return to target for another year. Given this, the economic agents have raised their inflationary expectations. For example, the non-financial corporates that set prices in the real sector of the economy expect inflation of 3.0% for the next two years, in other words at the upper limit of the range. This suggests that there could be difficulty in maintaining expectations anchored in the medium term, which is not desirable in a system of inflation targets. Second, the strength of domestic demand and increased growth prospects suggest that the current slack will not take long to be used up. This would not only have an impact on prices, but also on the balance of payments current account.

… but an eventual rise in the policy rate would exacerbate the pressures the strengthening of the local currency, in a context in which the effort to moderate them has been important

This situation suggests that it may be necessary to resume the process of adjusting the monetary position, above all now that the possibility of a very dangerous scenario in Europe has been limited. In fact, the Central Bank has already begun to do so as a preventive measure. However, rather than using its conventional instrument it has used reserve requirements to prevent increasing upward pressure on the local currency. We believe that the dilemma that is beginning to be faced by the monetary authority will in the future lead it to act in two ways. First, it will continue to support reserve requirements, despite the fact that these are already high. This will be its main instrument in the coming months if a tightening monetary stance has to be taken. Second, macroprudential measures will be coordinated with the other economic authorities. At present, the banking regulator has proposed increasing the capital requirements according to type, currency and credit maturity. This would apply particularly to the type of lending that is growing fastest, such as mortgages and consumer finance. In the case of mortgages, there would be an increase in the capital requirement in the following cases: when lending is in dollars and the borrower's income is in soles; when the finance is for buying a home other than primary residence; when the home's loan-to-value ratio is particularly high; or when the maturity of the loan is longer. Although the purpose of these measures is to ensure that financial intermediation develops in an orderly fashion, it could involve costs. Growth of demand for credit in Peru is based on structural elements, such as the fall in the level of informality and increased permanent income (improved productivity). Peruvian banks have a very low rate of non-performing loans and their indicators continue to be very sound. In this situation, the increase of financial penetration over recent years has only narrowed part of the gap with the rest of the region, and very severe macroprudential measures (the Peruvian authorities are perhaps those that have used them most after Brazil) could unnecessarily delay the process of convergence.

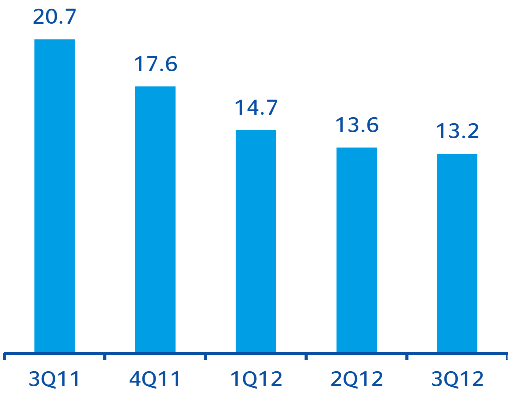
7. Measures that moderate credit and affect banking penetration

Credit continues buoyant in an environment of sound banking indicators

Bank lending to the private sector continues buoyant (Chart 23). In terms of products, consumer finance maintains its positive performance, as does mortgage lending in particular, while corporate lending has recovered slightly, above all for foreign trade, where there could have been a positive influence from the reduction in reserve requirements for these transactions[2], despite the weakness of the external sector. Credit has been buoyant in a strong banking system. The system has posted adequate profitability levels of close to 25% and levels of non-performing loans of under 2% (Chart 24). In addition, banks have levels of capitalization (Chart 25) that are in fact higher than those required by international regulations.

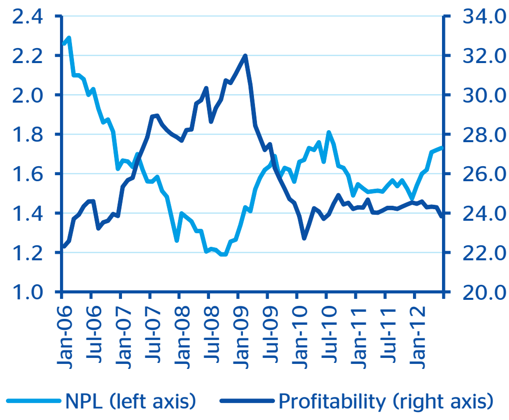
2: At the start of July, The Central Bank cut its reserve requirements for this type of transaction from 60% to 25% with the aim bringing the banks' conditions for financing foreign trade operations more into line with those of foreign banks.

Chart 23
Bank lending to the private sector (y/y % change)



Source: SBS and BBVA Research Peru

Chart 24
Profitability and non-performing loans in the banking system (%)

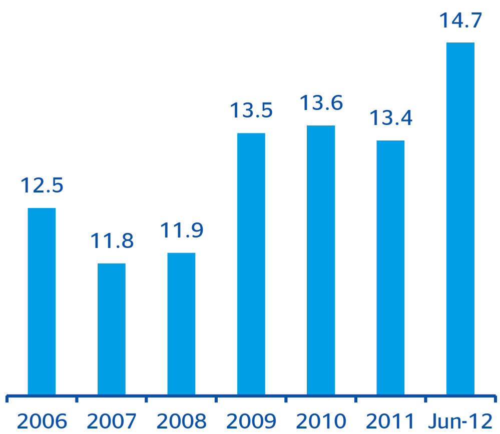


Source: SBS and BBVA Research Peru

From now on, the challenge is to continue to increase banking penetration while maintaining the strength of the system

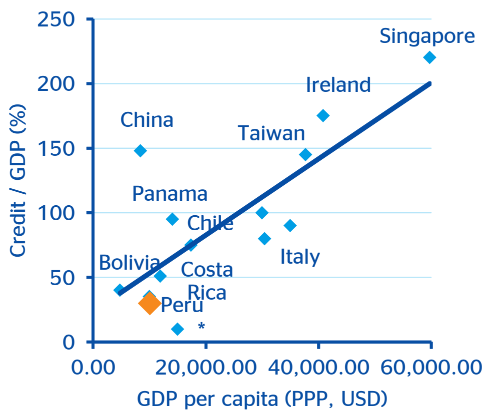
The authorities have been implementing macroprudential measures to ensure that credit growth is sustainable. The Central Bank has increased the average reserve requirement three times (September, October and November)[3] with the aim of moderating credit growth. At the same time, it has proposed increasing capital requirements, particularly for foreign-currency denominated loans and those with longer residual maturities. In the particular case of mortgage loans it proposes, for example, that capital requirements should be higher when the loan-to-value ratio is higher, the residual loan maturity is longer, the loan is in a foreign currency, or it is not for the purchase of a primary residence. However, the authorities should act carefully with these measures (including the adaptation to Basel III) given that part of the greater demand for credit comes from the growing proportion of the population that has only recently begun to access credit products.

Chart 25
Capitalization of the banking system (capital to risk-weighted-assets ratio (%)



Source: SBS and BBVA Research Peru

Chart 26
Financial intermediation and GDP per capita



Source: WEO, World Bank

3: The Central Bank has been using reserve requirements as a policy instrument to avoid any increased upward pressure on the local currency.

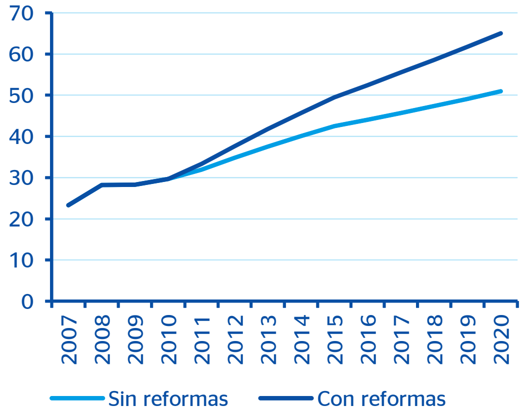
It is important to note that the level of banking penetration in Peru is relatively low compared with other countries in the region, even adjusted for income levels. We estimate that the ratio of credit to GDP in Peru should be around 10 pp above its current level (Chart 26). If more of the population is to benefit from access to the credit market, the level of informality in the economy has to be reduced further, and some institutional aspects have to be improved, such as access and quality of credit information, property rights (simplified procedures and cost reductions) and a legal framework that can enforce the execution of guarantees (Table 1). We estimate that with these improvements banking penetration would increase by 35 pp in the population by 2020; if they are not carried out, it would increase by 20 pp of GDP over the same period (Chart 27).

Table 1
Determinants of financial development

Structural factors	
Inflation	0,03
Spread	-0,39
Informal economy	-0.95***
Institutional factors	
Credit information index	4.15*
Property rights index	-3,87
Legal framework index	5.16**
Banking infrastructure	
Banking infrastructure	24.75***

***, **, * indicates significance at 1%, 5% and 10%, respectively
Source: BBVA Research Peru

Chart 27
Credit to GDP ratio in different scenarios (%)



Source: SBS, BBVA Research Peru

8. Europe continues to be the main risk factor

As we have pointed out in our most recent reports, the main risk factor for the Peruvian economy is Europe, although the chances of the risk occurring have been reduced due to the support by the European Central Bank in what is a difficult situation. If an "accident" were to occur along the path toward solving the problems of fiscal and financial sustainability, global financial tension would increase substantially. This accident could take place for a number of reasons: for example, if the fiscally stronger countries refuse to continue with the agreements reached; or the countries that have requested financial aid from European institutions did not meet their promised targets. The implications would be significant, both for the rest of the world and for Peru.

However, the Peruvian economy has strengths that would mitigate the possible impacts of this external shock. Its fiscal position has improved over recent years and it has room to implement countercyclical measures, while on the monetary side there are instruments available to make it easier to provide liquidity and support growth. In this scenario, output would slow to a rate of close to 4% in 2013, and somewhat above this in 2014, before gradually recovering. Of course, the public and foreign balances would be weakened, but this would be manageable. Fiscal stimulus measures and lower tax revenues linked with a slowdown in economic activity and lower export prices would lead to a fiscal deficit, though this would not be more than 1% of GDP in the forecast horizon. The downward trend in the public debt ratio would be temporarily interrupted, but it would resume as soon as global conditions begin to improve. In the external accounts, the balance of payments current-account deficit could reach around 3% of GDP at the most critical time.

9. Tablas

Table 2
Macroeconomic forecasts annual

	2010	2011	2012	2013
GDP (y/y %)	8.8	6.9	6.0	5.6
Inflation (y/y %, eop)	2.1	4.7	3.4	2.8
Exchange rate (vs. USD, eop)	2.82	2.70	2.58	2.50
Monetary policy interest rate (%, eop)	3.00	4.25	4.25	4.25
Private consumption (y/y %)	6.0	6.4	5.8	5.5
Public consumption (y/y %)	10.0	4.8	7.0	5.0
Investment (y/y %)	23.2	5.1	13.8	10.0
Fiscal balance (% GDP)	-0.3	1.9	1.7	1.5
Current account (% GDP)	-2.5	-1.9	-3.8	-4.2

Source: BBVA Research Perú

Table 3
Macroeconomic forecasts quarterly

	GDP (y/y %)	Inflation (y/y %, eop)	Exchange rate (vs. USD, eop)	Monetary policy interest rate (%, eop)
1Q09	1.9	4.8	3.18	6.00
2Q09	-1.2	3.1	2.99	3.00
3Q09	-0.6	1.2	2.92	1.25
4Q09	3.4	0.2	2.88	1.25
1Q10	6.2	0.8	2.84	1.25
2Q10	10.0	1.6	2.84	1.75
3Q10	9.6	2.4	2.79	3.00
4Q10	9.2	2.1	2.82	3.00
1Q11	8.8	2.7	2.78	3.75
2Q11	6.9	2.9	2.76	4.25
3Q11	6.7	3.7	2.75	4.25
4Q11	5.5	4.7	2.70	4.25
1Q12	6.1	4.2	2.67	4.25
2Q12	6.1	4.0	2.67	4.25
3Q12	5.9	3.7	2.60	4.25
4Q12	5.9	3.4	2.58	4.25
1Q13	6.3	3.4	2.56	4.25
2Q13	5.1	3.4	2.55	4.25
3Q13	5.4	2.9	2.53	4.25
4Q13	5.8	2.8	2.50	4.25

Source: BBVA Research Peru

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